Franchise Tax Board

ANALYSIS OF ORIGINAL BILL

Author:	Rev and Tax Committee	Analyst:	Gloria McConnell	Bill Number:	SB 2173
Related Bills:		Telephone:	845-4336	Introduced Date:	02/25/00
		Attorney:	Patrick Kusiak	Sponsor:	FTB

SUBJECT: Deficiency Assessments/Assignment of Lottery Winnings/Tax Exempt

SUMMARY

This bill, which is sponsored by the Franchise Tax Board, would:

1. allow the Franchise Tax Board (FTB) to continue its current practice of using tax returns (either paper or electronic) or information electronically captured from tax returns to make deficiency determinations. If a tax return or electronically captured return information is not available, the taxpayer would be notified and have 30 days to provide a paper or electronic copy of the tax return to FTB. Additionally, FTB would be required to provide a statement in tax booklets informing taxpayers that they may be requested to furnish FTB with a copy of the California or federal tax returns that are the subject of or related to a federal audit.

2. clarify that amounts received by a California lottery prizewinner from another person as a result of the prizewinner's assigning (transferring) the prizewinner's right to receive future lottery winnings would be exempt from state and local taxes.

EFFECTIVE DATE

This bill would be effective on January 1, 2001. The first provision expressly would apply to notices of proposed deficiencies issued on or after January 1, 2001. The second provision would apply to taxable or income years beginning on or after January 1, 2001.

IMPLEMENTATION CONSIDERATION

This bill generally reflects current practice; therefore, implementing this bill would not significantly impact the department's programs or operations.

FISCAL IMPACT

This bill generally reflects current practice; therefore, it would not affect departmental costs or tax revenue.

BOARD POSITION

Support. The FTB voted at its meeting of December 16, 1999, to sponsor the provisions contained in this bill.

Each provision is discussed separately in this analysis.

Board Position:			Department Director	Date
_X_ S	___ NA	___ NP	Alan Hunter for GHG	4/4/00
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___ N	___ OUA	___ PENDING		

DETERMINING TAX DEFICIENCIES

PROGRAM HISTORY/BACKGROUND

This provision is initiated in response to a California Court of Appeal decision filed December 21, 1998: Wertin v. Franchise Tax Board (1999) 68 Cal. App. 4^{th} 961. The taxpayer argued the Franchise Tax Board (FTB) failed to issue a valid notice of proposed assessment (NPA) because FTB had not reviewed the taxpayers' tax return prior to issuing the proposed assessment and thus had not validly determined the amount of tax due as required by statute. The FTB argued the trial court erred in applying federal case law and standards to a question of California tax law and FTB was not required to review the taxpayers' actual returns before issuing the notice of proposed assessment. The Court of Appeal held in favor of the taxpayer that a deficiency issued by the FTB was invalid because FTB issued its NPA without reviewing the taxpayer's tax return.

In the Wertin case, the basis for FTB's NPA was a federal audit determination for tax year 1983. The federal determination was final many years after the expiration of California's general four-year statute of limitation (SOL) for issuing NPAs. However, an IRS audit determination reopens the California SOL for issuing NPAs for that audit year. For federal audit determinations that were final prior to January 1, 1993, FTB had six months after receiving adequate notification from the taxpayer of the final Internal Revenue Service (IRS) determination to issue its NPA.

In the Wertin case, FTB did not have the original tax return filed by the taxpayer because the return had been destroyed during the department's routine annual purging of paper files. Returns are retained beyond the general SOL for issuings NPAs if flagged for special treatment, which is generally because an FTB audit is in process or it is known that a federal audit is pending. For Wertin and many other taxpayers, FTB is not aware of a pending federal audit until after California's general SOL has expired, so at the time the federal audit is final, the taxpayer's actual California paper tax return has been destroyed. Also for Wertin, FTB failed to obtain a copy of the return that the taxpayer stated he had in storage.

Although FTB did not review the Wertins' tax returns, it did review information on its records regarding their 1983 tax liability in order to arrive at its deficiency calculation. When a tax return is processed by the FTB, key data are captured and retained on an electronic data base. In the situation where an NPA is issued after a return is destroyed, staff reviews its electronic record that contains a summary of the taxpayer's return information and makes a determination as to the deficiency based on that information and federal information furnished by the taxpayer and/or the IRS.

The Wertin court said that its finding that the assessment issued to Wertin was invalid is consistent with Scar v. C. I. R. (814 F.2d at p. 1369) and federal standards. However, FTB staff disagrees. In Scar, the IRS had made an arbitrary deficiency assessment stating on the notice that since the original income return was unavailable at the time, the income tax was being assessed at the maximum tax rate of 70%. In contrast, in the Wertin case, FTB used information from the taxpayer's originally-filed California return that was electronically captured during return processing as the basis for the assessment.

FTB petitioned the California Supreme Court to review the Wertin decision, but that petition was denied. The case is now final and is a published opinion.

As a result of the Wertin case, any deficiency determination that FTB makes without reviewing the actual paper tax return may be held to be invalid. For the most part, the Wertin decision primarily affects FTB's assessments that are based on IRS audit reports, where the paper return that was filed is no longer available within the department. However, depending upon how the Wertin decision is interpreted, there could be an impact to FTB's current business practice of using electronically captured information whenever possible without pulling the tax return from storage.

SPECIFIC FINDINGS

Under federal statutory law, if there is a deficiency in any tax reported to the IRS, the IRS may issue a notice of deficiency (Internal Revenue Code (IRC) section 6212). Deficiency generally is defined as that amount that exceeds the tax shown by the taxpayer upon his or her return plus amounts previously assessed as a deficiency (IRC section 6211).

Under California income tax law, if FTB determines that the tax disclosed on an original or amended return is less than the tax disclosed by an audit, FTB shall mail a notice of proposed deficiency (Revenue and Taxation Code (RTC) section 19033) to the taxpayer. California generally conforms to the federal definition of deficiency (RTC section 19043).

Under FTB's current practice, all paper returns received by FTB are electronically processed and critical return information is captured to facilitate examining accounts without retaining or retrieving the actual tax return. FTB has many audit processes to determine whether a tax deficiency (or overpayment) exists, which includes those cases where the taxpayer has failed to file a personal income tax return. Determining the amount of the deficiency may require manual intervention or may be strictly an automated process. FTB may conduct an audit in the field using the records of the taxpayer or may conduct an audit using the filed tax return and correspondence, return information electronically captured and correspondence, or a combination of all information available to FTB, including IRS audit information. Because California generally conforms to federal law, reliance on a federal audit determination is a very cost-effective method for determining the California deficiency, if any. For example, for fiscal year 1998/99, using the federal audit determination process FTB assessed $230 million in personal income tax deficiencies, with a benefit to cost ratio of over $35 to $1.

As a result of all audit processes, and the taxpayer filing a personal income tax return, approximately $300 million in deficiency assessments were issued by FTB for fiscal year 1998/99. Staff estimates that of these assessments, the tax return would not have been available for deficiency assessments totaling $115 million, primarily because of the FTB practice of purging tax returns. Of the remaining $185 million in deficiency assessments, returns were not retrieved from storage due to FTB's current business practice of using electronically captured data to process NPAs based on federal audit determinations.

Head of household filing status audits have historically proven very cost-effective. For these audits, FTB staff relies on electronically captured return information and questionnaires completed by the taxpayer. The tax returns are not retrieved from storage. For fiscal year 1997/98, FTB disallowed the head of household filing status for approximately 93,000 taxpayers resulting in deficiency assessments totaling approximately $50 million. The cost effectiveness of these audits would be negated as a result of the Wertin decision if staff were required to retrieve each tax return from storage to make the assessment.

With respect to FTB's current case inventory, approximately 125 cases are under appeal and one case is in litigation where the underlying assessment is based on a federal audit determination. It is unknown whether these specific cases will be affected by the Wertin decision or would be affected by this proposed legislation. Additionally, the number of audits, assessments or protests in process that may be impacted by the Wertin decision or this proposed legislation is unknown at this time.

As an efficiency measure, many tax returns are sent to the FTB electronically. For electronically-imaged returns, a paper document is retained; however, for electronically-filed returns, which include telephone-filed returns, there is no paper tax return. During 1998, FTB received approximately 1 million electronically-filed personal income tax returns (including telephone-filed returns), which was a 131% increase from 1997. So far this year (2000), the electronic filing of 1999 tax returns has increased by 45% over last year at this time; 37% of the 1999 returns are being electronically filed, compared to 27% last year.

The FTB (and IRS) has used an extensive advertising campaign to encourage electronic filing of tax returns because it is more efficient for processing and storage. Furthermore, new technologies are being used to reduce the storage of paper returns. For 1999/2000, FTB will have spent approximately $6 million to lease approximately 122,000 square feet to store and maintain the personal and corporate paper tax returns under its current business practice of purging files in conjunction with the expiration of the general SOL for issuing a deficiency assessment. The FTB (and IRS) is moving toward eliminating paper tax returns.

Policy Considerations

- If the decision made by the Appellate Court in Wertin requires the department to review the actual tax return in lieu of electronically captured information, deficiency assessments totaling approximately $300 million per year could be at risk of invalidation.

- Staff believes the court's finding that the actual tax return must be reviewed before issuing any assessment of a deficiency is without merit since the Wertin's NPA was based on return information that was captured electronically from the actual paper return. This bill would clarify that it is appropriate for FTB to continue its practice of using electronically captured tax return information to determine tax deficiencies.

- The Legislature recognized the need for electronic communication and filings by enacting RTC 18621.5, which addresses filings with FTB by "electronic imaging technology" and defining "electronic technology" and "traditional medium." The court's conclusion during a time of major advances in electronic technology is detrimental to the operation of the department and reduces filing options for taxpayers.

- To reduce storage costs, add efficiencies, and help simplify the filing process, both the FTB and the IRS are using electronic technology to move toward a paperless filing environment. The Wertin decision could be a major obstacle in achieving this goal.

Technical Consideration

Section 1 of this bill adds legislative intent relating to this provision only and should be so referenced. The attached Amendment 1 reflects the suggested change.

NONTAXABILITY OF ASSIGNED LOTTERY WINNINGS

PROGRAM HISTORY/BACKGROUND

The California State Lottery Act of 1984 was approved as an initiative measure by California voters on November 6, 1984, and was codified as Chapter 12.5 of Division 1 of Title 2 of the Government Code (Sections 8880-8880.72).

The California State Lottery Act of 1984 provided (Section 8880.32(g) of the Government Code) that the right of any person to a prize could not be assigned (transferred), except that payment of any prize could be paid to the estate of a deceased prizewinner or to a person designated pursuant to an appropriate judicial order. The Director of the California Lottery, the Lottery Commission, and state were discharged of all further liability upon the payment of the prize.

In 1994, the California State Lottery Act of 1984 was amended (AB 3542, Stats. 1994, Ch. 890) to authorize a prizewinner to transfer the rights to a lottery prize as collateral for an obligation. The amendment was made for prizewinners, particularly elderly persons or those seeking to acquire a small business, who wished to accelerate the receipt of their winnings. In 1995, the Act was again amended (AB 218, Stats. 1995, Ch. 363). In essence, these amendments condition the ability to transfer, as collateral, the right to receive future payments of lottery winnings, subject to a number of statutory requirements that cannot be waived or modified by the prizewinner. Approximately two years ago, according to lottery commission staff, changes were made in the manner in which winnings are paid. Currently, a prizewinner has an option of taking the prize in a lump sum amount (cash value), which is roughly half the face value, rather than receive 26 annual payments for the face value of the winnings; whereas previously the prizewinner had no option except to receive 20 annual payments or transfer his/her rights to future payments to accelerate the receipt of the winnings and receive a lump sum.

An example of a transfer of rights to future payments to accelerate the receipt of winnings under the 20-year pay-out is as follows: Assume an individual is the winner of a $20 million jackpot in the California SuperLotto during 1994. As the sole grand prizewinner, the individual is entitled to receive 20 annual payments of $1 million (face value). However, in late 1999, after receiving the first five payments of $1 million each, the individual voluntarily transfers to a secured creditor, as collateral, the right to receive the remaining 15 future payments in exchange for the prizewinner receiving a lump sum payment of $8 million (cash value).

According to the California State Lottery Commission, 1,061 prizewinners have transferred, in whole or part, their lottery winnings as allowed by law. The amount of lottery winnings attributable to those winners was approximately $482 million, of which the cash value of the winnings is not known.

Other conditional requirements for transferring lottery prize rights are as follows:

- If used as collateral to secure a loan, the transfer must be made pursuant to specified provisions of the Commercial Code.
- If the prizewinner defaults on the loan or security agreement, the secured creditor's rights are limited to receiving the prizewinner’s regular payments made by the lottery commission.
- The prizewinner and secured creditor may agree to have the lottery commission directly deposit all prizewinning payments into a bank account that is subject to the secured creditor's lien.
- The prizewinner may direct the lottery commission to make the prize payments, in whole or in part, directly to the secured creditor.
- The money must be paid in full to the prizewinner in consideration for the transfer of the prize payment before the lottery commission is required to make the first prize payment to the transferee.

As an initiative measure, the California State Lottery Act of 1984 provides that none of its provisions may be changed except to further its purpose by a bill passed by a two-thirds vote of each house of the Legislature and signed by the Governor.

The Oregon Tax Court recently addressed the issue of the taxability of lump sum proceeds received from the assignment of future lottery payments under prior Oregon state lottery statutes. (Maginnis v. Department of Revenue (January 25, 1999) Case No. 4310, Oregon Tax Court, Regular Division, Decision on Defendant's Motion for Reconsideration (April 12, 1999) 1999 Ore. Tax LEXIS 24.) In Maginnis, the Oregon Tax Court held that the lump sum payment received in exchange for assignment of the right to receive future payments was exempt from Oregon personal income taxation. The Oregon court reasoned that the "taxpayer was awarded the prize in 1991, and that right is exempt from taxation by the state. . . . [since] the effect of the exemption statute is to place the prize in the hands of taxpayer free of tax obligations. . . ."

SPECIFIC FINDINGS

Under the California State Lottery Act of 1984:

- Prizewinners are allowed to transfer to other persons, under certain circumstances, their right to lottery winnings and the future payments thereof.
- State or local taxes cannot be imposed upon the sale of lottery tickets, shares of the lottery or any prize awarded by the lottery.
- Property taxation or license fees are not prohibited for any non-cash prizes awarded by the California Lottery Commission.

Under state tax law, it is unclear whether lump sums received by prizewinners as a result of allowed transfers ($8 million in the above example) are merely the acceleration of the future payments of lottery winnings due the prizewinner and, therefore, exempt from taxation, or would be treated as ordinary income, and hence, taxable to the prizewinner. **Under current practice,** such transactions have not been taxable to the prizewinner.

Under this bill, any amount received by a prizewinner due to an allowable transfer of rights to future lottery payments expressly would not be subject to state and local taxes, e,g., lump sums, such as that described in the above example.

Policy Consideration

To allow lottery prizewinners the right to transfer winnings so that prizewinners may enjoy more of the winnings currently, and then tax the prizewinner upon his/her receipt of that lump sum amount, most likely was not the intent. This provision would clarify prospectively the statute's likely original intent that these transactions would not be subject to tax. However, to assure that the tax exempt treatment applies to prior year transaction, the bill should be amended to include language that specifies it is declaratory of existing law.

Technical Considerations

To correct the structural format of this provision, it is suggested that subdivision (d) be renumbered to be paragraph (2). Amendments 2 and 3 reflect the suggested changes.

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FRANCHISE TAX BOARD’S
PROPOSED AMENDMENTS TO SB 2173
As Introduced 02/25/00

AMENDMENT 1

On page 2, line 2, after "made by" insert:

Section 3 of

AMENDMENT 2

On page 2, lines 8 and 9 strike out “Except as provided in subdivision (d)” and insert:

(1) Except as provided in paragraph (2)

AMENDMENT 3

On page 2, line 17, strike out “(d)” and insert:

(2)